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Soviet Economic Problems and Outlook

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SOVIET ECONOMIC PROBLEMS AND OUTLOOK

THE PROBLEM

To review, briefly and in general terms, current Soviet economic policies and problems, and to assess the course, implications, and overall outlook of the Soviet economic scene over the next few years.

SUMMARY AND CONCLUSIONS

A. A number of serious long-run problems in the Soviet economy have recently reached an acute stage. Overall growth is lagging, various sectors of the economy are intensifying competition for scarce resources, agricultural production is falling far short of needs, large wheat purchases in 1963 have greatly aggravated the hard-currency deficit, and gold stocks are nearing a critically low level. This situation is due in part to chronic Soviet mismanagement, but mainly to the burdens imposed on the economy by a series of programs too ambitious for available resources. The demands of defense and space have greatly encumbered economic growth since 1958. Recently, industry has been adversely affected, as well as agriculture and the production of consumer goods. (*Paras. 1-4*)

B. Soviet leaders have now launched a new effort to cope with their most intractable economic problem—the stagnation of agriculture—through a large expansion of the chemical industry, especially for the production of fertilizer. They apparently expect to finance this program from the expansion they anticipate in the economy, from cutbacks in some nondefense programs, and from large and long-term Western credits. But we also

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think that the Soviets will make every effort to hold down defense and space expenditures so as to release scarce resources for investment in the civilian economy. (*Paras. 6-8, 10, 18, 20*)

C. While defense expenditures may decline, we think it more likely that they will continue to grow, though at a slower pace than in the recent past. In the short term, the Soviet leaders have the option of reducing force levels, but in the long term they must consider the advisability of curtailing or stretching out one or more programs for advanced weapons. (*Para. 20*)

D. The Soviets will make sustained efforts to expand trade with the West, and particularly to obtain large and long-term Western credits. This will help foster continued restraint in the tone of Soviet foreign policy, though not major concessions of substance. (*Paras. 21, 22*)

E. Over the next few years, investment in agriculture and the chemical industry will greatly increase, partly as a result of the policies above outlined, partly from the natural growth of the total Soviet economy. However, chances of restoring previous high levels of industrial growth are slim, and the innate rigidities of Soviet planning and administration will continue to hamper the economy. Many of the chemical program's current targets will almost certainly not be met, agricultural production will fall far short of projected goals, and significant benefits to the consumer will be several years in the making. (*Para. 25*)

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DISCUSSION

I. RECENT DEVELOPMENTS

A. Background

1. The USSR is now in a period of increasingly severe competition for resources among various sectors of its economy. The decline in recent years of both the overall and the industrial rates of growth, the disastrous agricultural year in 1963, the consequent purchases of wheat from Western nations, and the further drain this has imposed on the USSR's limited gold stock are the dramatic highlights of a troublesome situation which has been developing since 1958. These economic difficulties are beginning to have a major impact on the domestic, foreign, and military policies of the USSR.

2. The annual growth of the Soviet Gross National Product (GNP), which had averaged an estimated 6.5 percent in the decade of the 1950's, has averaged only about an estimated 4 percent over the last four years and has been below the US rate for the past two. The annual growth of new fixed investment, which had been about 15 percent, dropped to an estimated 8 percent in 1960, and has since hovered between 4 and 5 percent. Estimated defense and space expenditures, which had declined in both 1956 and 1957, began to grow again in 1958, and by 1963 were about 40 percent higher than in 1958. Agricultural production actually declined some 4 percent in 1962 and 4.5 percent in 1963; it now stands slightly below 1958 levels and as much as 10 percent below on a per capita basis.

3. It appeared to us last year that the problems of the Soviet economy had reached an acute stage.¹ Increased defense expenditures, which were largely responsible for the squeeze on resources, also restricted the kinds of expenditures which might have increased growth rates. The Soviets made a number of moves to increase growth, particularly in agriculture, but they were short range expedients and largely unsuccessful; they relied on inaccessible or nonexistent "hidden reserves" or on solutions which were self defeating. It seemed to us that the time had clearly come for the Soviet policy makers to make some difficult new decisions concerning priorities in the allocation of resources.

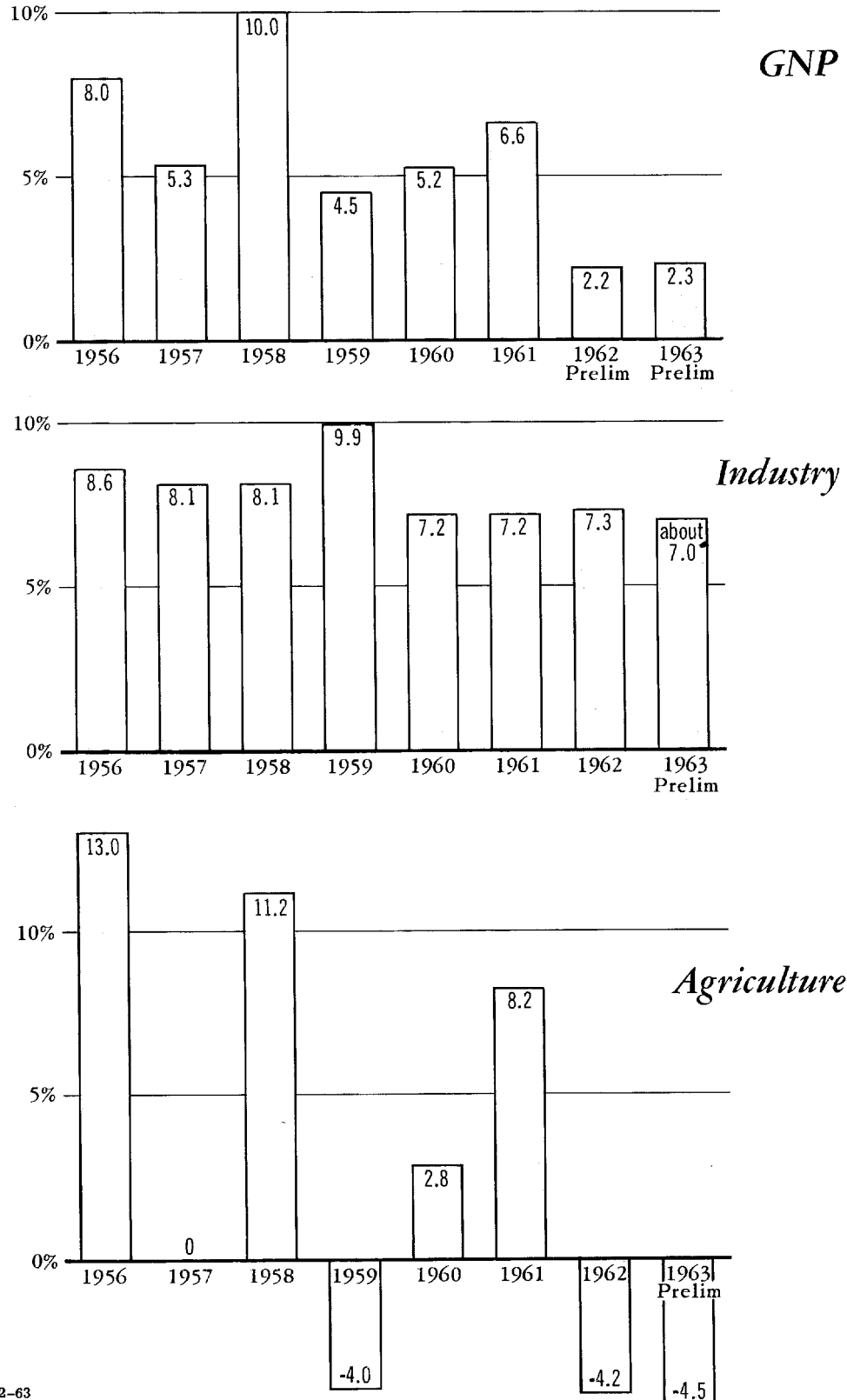
4. But, because emphasis on heavy industry and neglect of consumer interests has long been the pattern, powerful vested interests have had the ability to resist efforts to alter the status quo. There has been a continuing struggle between those who believe that the national interest requires greater attention to an invigorated agriculture and those who

¹ See NIE 11-5-63, "Soviet Economic Problems," dated 20 March 1963. SECRET.

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Figure 1

USSR: Estimated Annual Rates of Growth in GNP, Industry, and Agriculture, 1956-1963

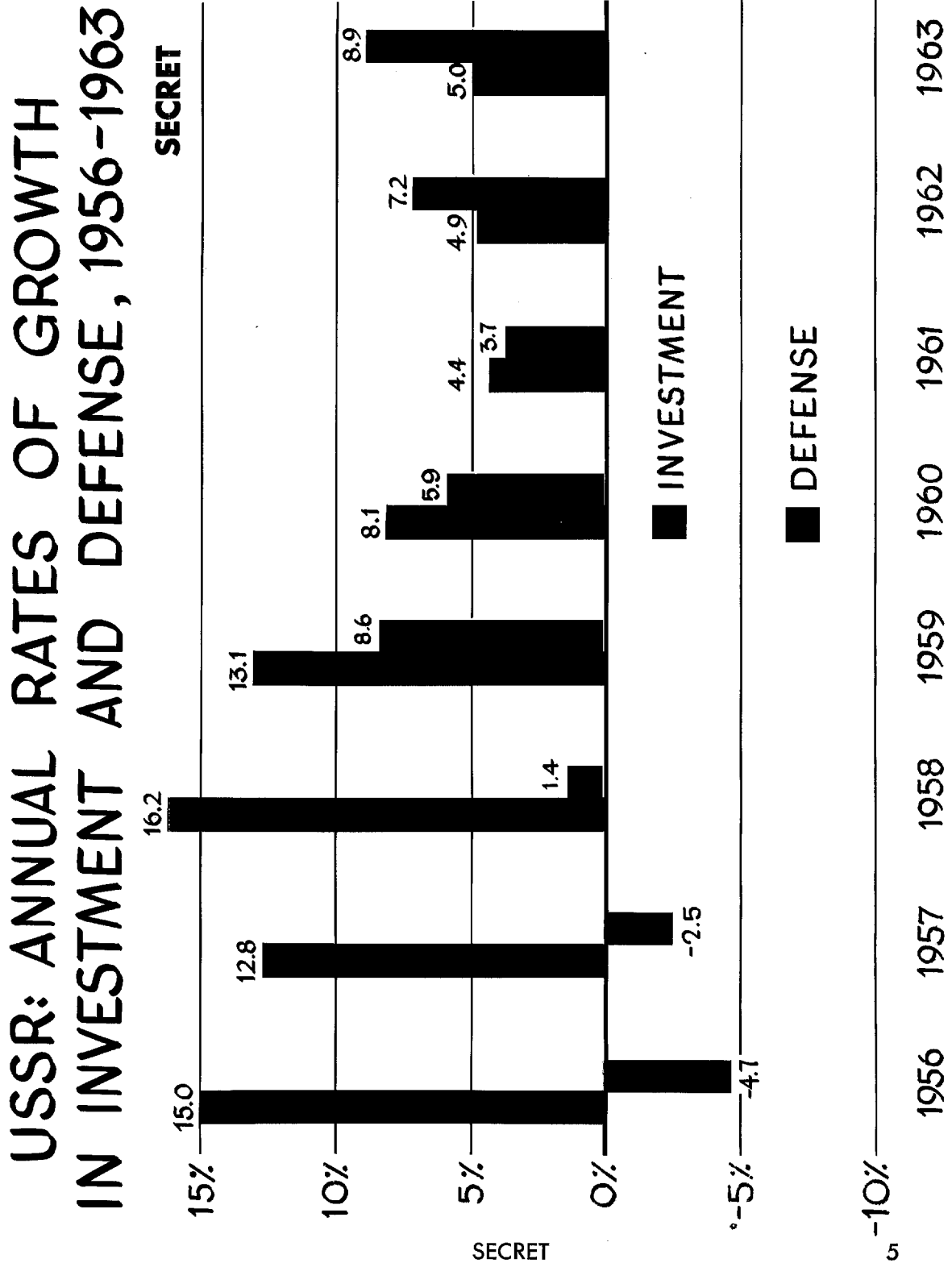


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Figure 2



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oppose any weakening of the priority accorded the development of heavy industry and a pre-eminent defense establishment. Attitudes toward military doctrine have evolved which are appropriate to those positions. Khrushchev, though a stout advocate of great military power, has placed stress on advanced weapons and deterrence, whereas others have sought to maintain a more traditional (and more expensive) balance of forces and to provide the armed forces with broader war fighting capabilities. Thus, recent Soviet economic policy has been characterized by pulling and hauling, contention and compromise, and an unrealistic attempt to advance on all fronts simultaneously.

5. Khrushchev has long sought to identify himself with the aspirations of the Soviet people for a better life and, over the years, has emphasized the importance of agricultural production and material incentives. His speech of February 1963, in which he called attention to the tremendous burdens of military spending and gave scant hope for any marked improvement in living standards in the immediate future, thus seemed to many observers to have been out of character. Since last spring, however, Khrushchev's statements concerning the economy no longer echo the extreme pessimism of his February address. On the other hand, his sober assessment of the import of this year's poor harvest reflects an increasing awareness of the need for effective remedial measures.

B. The Competition for Resources

6. The Soviet leaders are now calling for a major modernization of the economy through the expansion of the chemical and related industries, and with increased emphasis on agriculture and consumer goods. They appear determined to commit the very substantial resources required. As formally presented by Khrushchev on 9 December at the Central Committee plenum, the new program calls for a total outlay of some 42 billion rubles through 1970.² If actually carried out, this means that annual investment in the chemical industry will rise from the present 10 percent of total industrial investment to 18 percent. Among the specific goals of the program are production increases in fertilizers (from 20 million tons to 70-80 million), plastics and synthetic resins (from 580,000 tons to 3.5-4.0 million tons), and chemical fibers (from 310,000 tons to 1.35 million tons). Some 200 chemical plants are to be built, 500 existing plants expanded or rebuilt, and the output of the chemical machine building industry is to increase fourfold.

²The appropriate ruble-dollar conversion ratio for this program is unknown. However, the quantity of domestic resources that the USSR would have to invest to accomplish these goals would amount to the equivalent of much more than \$46 billion given by the official exchange rate.

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Khrushchev has cast this program largely within the context of its anticipated benefits to the consumer, though its military significance has also been stressed.

7. Khrushchev apparently recognizes that the needs of this new program will clash with those of other claimants. He has implied that the resources earmarked for the expansion of the chemical industry will come in part from the overall growth of the economy, from imports, and from the diversion of funds from communal services and housing construction. He has referred to the necessity of temporary slowdowns in certain other sectors of the economy. And, along with the announcement of his chemical program, he also noted the need to study possible reductions in the strength of the armed forces and introduced a defense budget calling for modest reductions in expenditures during 1964.

8. This announcement of a 4 percent reduction in the military budget is not conclusive, since in recent years only an estimated two-thirds of defense expenditures have been included publicly within the appropriate category. But its implications of a reduced rate of military expenditures seem to be borne out by announced plans for the machine building industry. In Soviet statistical data, the total output of that industry includes not only equipment for the civilian economy, but also finished military hardware. One way of analysing how fast military procurement is growing is to compare the rate of increase in total output of the machine building industry with the rate of increase of its non-military output. For the past several years, non-military production of the industry has increased at a slower rate than total output, reflecting the growing share of military procurement. Current plans, however, indicate an opposite trend, i.e., that non-military procurement will be a growing share and military procurement a declining share of the industry's output. This year, while total machine-building output is scheduled to rise by 10 percent, the non-military portion is to grow by 13-15 percent. If this in fact transpires, then while production of weapons will continue to increase, the rate of increase will be less than in the past. That the effects of the new program on defense are well recognized by Khrushchev has been suggested by his moves in other areas of policy, particularly those affecting the international climate.

C. Foreign Economic Policies

9. The problems of the domestic Soviet economy have of necessity spilled over into the area of the USSR's foreign economic activities. Trade with Western states has been stepped up in order to compensate for the inferior technological level of certain Soviet industries, to secure advanced equipment not available at home, and most recently, to obtain great quantities of grain to make up for the bad harvest in 1963. The newly expanded chemical industries program will require substantial

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imports from both Eastern Europe and the West. Khrushchev has stated that the USSR is in the market for Western equipment and whole plants "if credit is available . . . and no political conditions are attached." Our preliminary estimate is that the USSR might need in the neighborhood of \$2 billion of Western chemical equipment between now and 1970; if they decided to rely extensively on the West for advanced equipment and engineering, and were able to finance it, imports could be substantially higher. The Soviet leaders almost certainly see little chance of a substantial increase in their own export earnings and consequently hope that a major part of their expanded needs can be supplied on the basis of long-term credits from the West.³

10. *Trade Deficits with the West.* Imbalance of trade with hard-currency nations of the West has become acute in recent years. The USSR imported roughly \$200 million in machinery from the West in 1958 and some \$600 million in 1962. The hard-currency deficit jumped from about \$100 million in 1959 to \$350 million in 1962. Scheduled imports of grain from the West (excluding any grain purchases from the US) could bring the total trade deficit to more than \$700 million in 1964. Until 1960, deficits were financed largely through sales of gold. Since 1960, a greater share of the deficit has been financed through medium-term credits, which reached a total of \$575 million outstanding at the end of 1963. This, in turn, has necessitated a rising level of credit repayment. In 1963, for example, the USSR may have obtained some \$300 million in new credits, but repayments plus interest amounted to some \$240 million.

11. *Gold Sales.* We estimate with some confidence, as a result of a recent comprehensive review, that the USSR had a total gold stock of some \$3 billion in 1955 and that this had been reduced to a figure of \$1.8 billion at the close of 1963.⁴ The Soviets are now drawing heavily on gold stocks to finance grain imports; gold sales totalled some \$210 million in 1962 and may have run as high as \$500 million during 1963. Domestic production may have reached \$175 million in 1963 but this would represent a new high. Gold reserves may sink to about \$1.3 billion in 1964⁵ even with no grain purchases from the US. If this is so, the Soviets could significantly expand their imports from the West only by obtaining long-term credits.

12. *Non-Bloc Economic Aid.* New extensions of Soviet economic assistance to 25 non-Communist countries increased sharply from 1954 to

³ The Soviets have been receiving substantial medium-term credits (5-6 years) from the West, but now need long-term credits (10 or more years) because of the current high level of interest charges and repayments.

⁴ This figure does not include Soviet holdings of foreign currency which fluctuate between \$200 and \$300 million.

⁵ This could be deferred somewhat by short-term borrowings.

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TABLE 1

USSR: Method of Financing the Trade Deficit, 1955-63

| Year | Trade Surplus or Deficit with the Industrial West ^a | Hard-Cur- rency Surplus or Deficit ^b | Sales of Gold ^c | MILLION CURRENT U.S.\$ Addi- tional Medium- Term Credits from the Indus- trial West (Net) ^d |
|------|---|---|-------------------------------|---|
| | | | | |
| 1955 | 75 to 85 | 10 | 70 | N.A. |
| 1956 | -20 to -40 | -90 | 154 | N.A. |
| 1957 | -45 to -65 | -185 | 275 | N.A. |
| 1958 | -20 to 5 | -135 | 182 | N.A. |
| 1959 | 25 to 50 | -95 | 303 | 40 |
| 1960 | -175 to -210 | -300 | 125 | 168 |
| 1961 | -110 to -160 | -250 | 310 | 135 |
| 1962 | -250 to -285 | -350 | 210 | 117 |
| 1963 | N.A. | N.A. | 500 | 61 |

^a Adjusted for estimated net freight costs.

^b As a result of trade with the total non-Communist world.

^c Minimum estimates.

^d The USSR almost certainly obtained no medium-term credits from the West before 1959. Figures in this column include an allowance for interest at an annual rate of 5 percent.

TABLE 2

USSR: Production, Disposition, and Reserves of Gold ^a 1955-63

| Year | Pro- duction | Sales ^b | DISPOSITION | | Change in Reserves | Reserve Balance at the End of the Year |
|-------------------|-----------------|--------------------|--|--|-----------------------|--|
| | | | Other Withdrawals (Net) ^c | | | |
| 1955 | 121 | 70 | 32 | | 19 | 3,044 |
| 1956 | 117 | 154 | 42 | | -79 | 2,965 |
| 1957 | 119 | 275 | 22 | | -178 | 2,787 |
| 1958 | 124 | 182 | 29 | | -87 | 2,700 |
| 1959 | 132 | 303 | 25 | | -196 | 2,504 |
| 1960 | 137 | 125 | 43 | | -31 | 2,473 |
| 1961 | 147 | 310 | 43 | | -206 | 2,267 |
| 1962 | 156 | 210 | 43 | | -97 | 2,170 |
| 1963 ^d | 175 | 500 | 43 | | -370 | 1,800 |

^a One troy ounce of gold is valued at US\$35.

^b Minimum estimates.

^c Excess of consumption and other disposition above other acquisitions.

^d Preliminary.

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1959, over \$800 million being committed in the latter year. Following some retrenchment in 1960 and 1961, new extensions fell to a low of \$77 million in 1962 and did not exceed \$200 million in 1963 as the USSR applied stricter criteria for the extension of new credits.⁶ This marked decline cannot, of course, be attributed solely to a resource squeeze within the USSR; the rapid growth of aid to Cuba, continued assistance for Communist countries other than China, growing emphasis on military aid, and questions of opportunity and political benefits are certainly contributory factors. Nevertheless, the reluctance of the Soviet leaders to extend aid to countries which offer but small hope of quick political gains, has almost certainly been reinforced by the domestic competition for increasingly scarce resources and by the overall slowdown in Soviet economic growth.

II. OUTLOOK

13. Khrushchev's new programs will almost certainly yield some positive results, but it is questionable that the leadership will move fast enough, efficiently enough, and drastically enough to put the USSR onto a path of resumed rapid economic growth in all the vital sectors of the economy. Commitments to certain programs and to the maintenance of existing establishments, particularly in the area of defense, will continue to retard progress in other areas. And there remain the twin hindrances of Marxist ideology and party mismanagement. Finally, favorable weather is of crucial importance, one more year of drought would have very serious consequences.

14. The Soviet economy is too large, too clumsily managed, and too complex to change gears overnight. There will be bureaucratic footdragging and resistance to innovation on a vast scale. Khrushchev has called attention to the tendency of planners to depend almost entirely on the patterns of previous years and to ignore new instructions. Various other factors, such as the relative lack of material incentives for the workers, may also inhibit change and improvement. But, just as important as any of these, the determination of the party apparatus and its leaders to interfere in and to exercise control over all aspects of economic planning and production will greatly hamper the efforts of the professional managers and economists to rationalize structure and improve output.

15. The most serious problem for the Soviet leaders as they seek to implement their new economic program will be the requirements of their large and expensive military establishment. The newer, more complex weapons systems account for most of the increase in military

⁶ A total of \$3.4 billion has been extended, of which more than \$2 billion has as yet to be withdrawn. In 1963, about \$400 million was used by recipient countries.

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expenditures since 1958; indeed, we estimate that the procurement expenditures for missiles, nuclear warheads, and ground electronics during 1963 were as large as the total of all military procurement in 1958. These weapons systems consume increasing amounts of many of the critical resources needed for the fulfillment of the civilian investment programs. In particular, the burgeoning needs of the chemical industry will require high quality and scarce material and human resources, and will compete directly with the military for both equipment and engineers.

16. The Soviet leaders will find it extremely difficult in the short term to get the necessary resources by transfers from military programs. A modest reduction in the conventional ground forces would be insufficient to finance a significant proportion of the contemplated investment in the chemical industry over the next several years. Even if large reductions were made in the ground forces, savings in the resources and skilled manpower needed in the chemical industries would be relatively minor.

17. To meet such needs through cutbacks in modern weapons systems would be extremely difficult. The leaders could cancel various expensive military and space projects now only in the planning and development stages, but this would provide little relief in the short term. They could not expect to make additional critical resources available in large quantities at any early date without substantially reducing investments in expensive current projects, such as production and deployment of nuclear warheads and advanced missiles. Quite apart from overall concern about the effect on the Soviet defense posture, such cuts would be highly uneconomical, and would encounter strong resistance from the military.

18. Some reductions in civilian investment programs are almost certain. The steel industry, a favorite target of Khrushchev's, has already had its rate of growth reduced to about six percent per year for 1964 and 1965 and it may be cut even further. In housing and civil construction, there have already been reductions in plans, and signs are that the pace is to remain moderate.

19. Restrictions on Soviet space activities might, over the long term, provide important investment sources and skilled manpower. Our knowledge of the planned scope of the Soviet space program is limited. But some restrictions have been suggested by the USSR's declaration of intention not to orbit space weapons, together with Khrushchev's recent remarks which, though vague, suggested that the USSR would not compete with the US in a race to achieve a manned lunar landing during this decade. Any major and obvious curtailment of space activities, however, would cost the USSR some measure of international prestige, and might, in addition, have a detrimental effect on certain military or military-related projects.

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20. We think that the Soviets will make every effort to hold down defense and space expenditures so as to release scarce resources for investment in the civilian economy. While defense expenditures may decline, we think it more likely they will grow at a slower pace than in the recent past. In the short term, the Soviet leaders have the option of reducing force levels, but in the long term they must consider the advisability of curtailing or stretching out one or more programs for advanced weapons.

21. The campaign to gain greater and longer term Western credits will certainly be stepped up over the next few years. Failure to gain the desired credits would force cutbacks in civilian goals, particularly those in the chemical industry, or further restrictions on defense spending.

22. The new program cannot approach its announced goals without eventual diversion of domestic resources from other claimants, particularly military. Nor can it succeed without substantial improvement in the Soviet position with respect to foreign trade and credit. Both these necessities argue for a foreign policy of relative restraint, designed at least to keep international tension from rising and perhaps even to diminish it. We do not, however, believe that the Soviets would make major concessions in exchange for expanded Western credits or reduced Western defense expenditures.

23. Economic aid to non-Bloc countries is unlikely to recover the momentum of earlier years. We attribute this more to psychological and political factors than to any real shortages of available resources; it is difficult for the leaders to justify, even in their own minds, shipments of Soviet goods abroad when they are not plentiful at home and when the effect of such shipments remains uncertain or remote. But, while the Soviets may become even more selective when extending new credits, they still view the program as potentially rewarding, and commitments already made will keep them active in this field for the next several years.

24. Despite indications in the recent Central Committee plenum and the 1964 budget that the Soviet leaders have at last faced up to the hard choices, it would be wholly in character if they continue partly to rely on "hidden reserves" and various administrative reorganizations. To achieve all their currently projected aims, as in agriculture, would require precisely the sort of radical changes they are least likely to make in the foreseeable future, as, for example, allowing considerable private initiative on the farms and decentralizing the economy.

25. Over the next few years, investment in agriculture and the chemical industry will greatly increase, partly as a result of the policies above outlined, partly from the natural growth of the total Soviet economy. However, chances of restoring previous high levels of industrial growth

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are slim, and the innate rigidities of Soviet planning and administration will continue to hamper the economy. Many of the chemical program's current targets will almost certainly not be met, agricultural production will fall far short of projected goals, and significant benefits to the consumer will be several years in the making.

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Figure 3

USSR: Economic and Military Assistance to Non-Communist Underdeveloped Areas*, 1954-1963

Millions of US dollars

1400

1200

1000

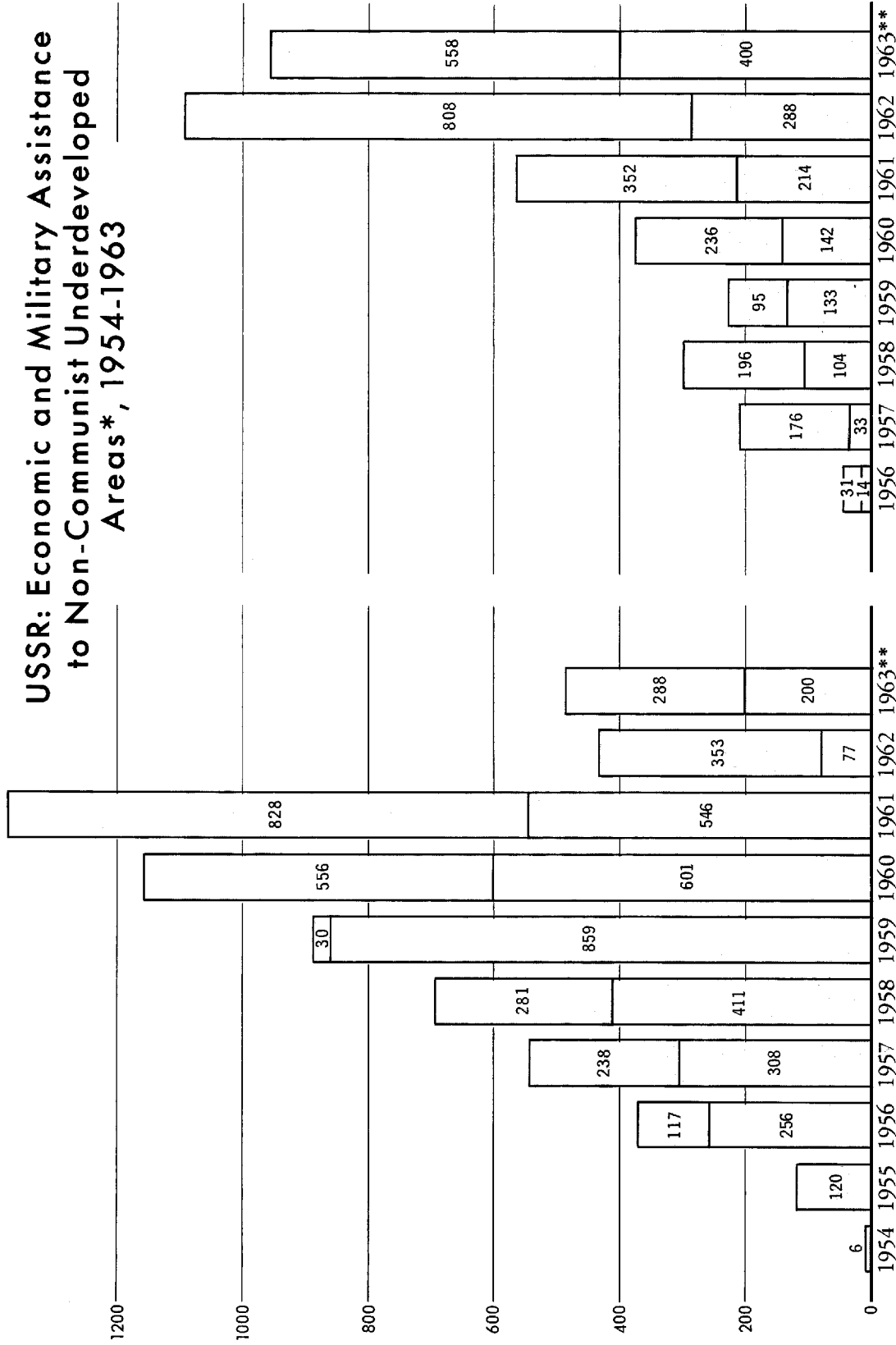
800

600

400

200

0



A. AID EXTENDED

*Includes the following countries of the Free World: (1) All of Latin America except Cuba; (2) All of the Middle East, including Cyprus, Greece, Syrian Arab Republic, Turkey and the United Arab Republic (Egypt); (3) All of Africa except the Republic of South Africa; (4) All of South and Southeast Asia; and (5) Iceland, Portugal and Spain.

** Preliminary estimate.

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